RSC Republican Study Committee
Financial Services Working Group
Congressman Scott Garrett (R-NJ), Chairman
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TAXPAYERS, GIMME ALL YOUR MONEY!

Senate Financial Services Reg Reform Update
Down to the Wire

Cloture was filed Monday night for the Senate's financial services regulatory reform bill, S. 3217, and the cloture vote is scheduled to take place this afternoon.

The expectation is that the Senate will complete its business on the bill by Friday. Also, it is widely speculated that the House and Senate will hold a conference on the bill, should the bill pass the Senate.

Bottom Line: This bill is bad, and amazingly, the amendments offered during Senate consideration made it worse.

Worst of the Worst: The Highlights

1. **Consumer Credit Restriction Bureau** – A new entity will limit access to credit for consumers and small businesses, by determining the "appropriateness" of financial products such as mortgages, credit cards and student loans.
2. **Decreased Risk Management for Businesses** – Derivative products that hedge a unique business risk, such as the risk of a bad tomato crop to Campbell's soup, are under attack by politicians who demonize them rather than develop a sophisticated understanding of their uses. The financial crisis was exacerbated by the failure of many companies to adequately manage their risk…..so….the Democrats' solution is to ban risk management tools…
3. **All-Powerful Federal Reserve and Treasury Department** – The Fed's powers are greatly expanded in this bill, without transparency to American taxpayers – under this bill, if the Obama Administration doesn't like the CEO of a company, they can have the CEO removed. Seriously. They can decide for any reason that a business should sell off a portion of its company. This legislation does not bind the Administration's hands with any specific criteria – it gives them practically limitless power.
4. **Fountain of Taxpayer Dollars for Fannie Mae and Freddie Mac** – Open your wallets for more bailouts, because this legislation gives Fannie and Freddie the green light to misbehave. Fannie and Freddie are the largest recipients of government assistance since the crisis began and are projected to cost taxpayers almost $400 billion. By not even addressing them in this bill, Democrats are giving Fannie and Freddie the go-ahead to continue to ask for unlimited amounts of taxpayer dollars.
5. **Promise of Future Taxpayer-Funded Bailouts** – The last two years have seen unprecedented actions of government intervention in the private markets. Thanks to the government's use of taxpayer dollars to bail out Bear Stearns, Fannie Mae and Freddie Mac, AIG, General Motors, Chrysler and practically the entire financial sector, the floodgates have been left open for future bailouts. From now on, every company teetering on the edge of failure won't look to curtail its risk-taking activities; it will look to the government for salvation. This bill does nothing to end this shocking abuse of taxpayer dollars, thus ensuring future use of the American taxpayers as ATMs for big banks.

Republicans have a better plan, which provides transparency and accountability to American taxpayers, and puts an end to all bailouts.

The components of the Republican financial services regulatory reform proposal are as follows:

- No more bailouts: banks that fail should be subject to our bankruptcy laws
- Creation of a Market Stability and Capital Adequacy Board to monitor risks in the financial system
- Regulatory restructuring to ensure for greater effectiveness in financial oversight
- Reform of the Federal Reserve which refocuses the Fed on monetary policy
- Ending taxpayer subsidies of Fannie Mae and Freddie Mac
- Consumer protection through the Financial Literacy and Education Commission
- Strengthening anti-fraud enforcement

For more information on the Republican alternative please click here

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THE WALL STREET JOURNAL

The Clearinghouse Rescue Plan
Taxpayers will still be on the hook for risks in derivatives trading.

As miracle cures go, clearinghouses for derivatives seem to be everyone's favorite. By requiring that most swap contracts be settled daily through institutions that collect and spread financial risk, Congress and Treasury claim that we can all sleep better at night without fear of more AIGs.

Sorry to break this reverie, but if this is true, why does Senator Chris Dodd's financial bill give clearinghouses access to the Federal Reserve's discount window? That's the special Fed lending facility that is typically available only to banks that can't get the funding they need elsewhere. Does the Senator know something most Americans do not?

Apparently so. Mr. Dodd is saying that clearinghouses can also fail in a crisis, and so he also wants the Fed to be able to provide them with liquidity so they don't fail. Hmmm. Maybe this clearinghouse cure isn't so miraculous after all.

To be clear, clearinghouses for derivatives have their uses. Participants put up money to join, and the clearinghouse keeps the cash for emergencies. Based on the trading positions of participants, the clearinghouse also collects cash margin every day. If defaults by one or more members burn through the entire pot of cash, the clearinghouse will ask the remaining members to chip in.

The risk comes if the defaults burn through these member resources. In that case, Mr. Dodd is signaling that taxpayers will be called upon to help. Regulators are selling this Beltway re-engineering as a way to offset the "interconnectedness" of financial firms in the over-the-counter derivatives market. But clearinghouses are the most interconnected of all institutions—by design.

Clearinghouses do have a generally good record for trading in futures and other things, but they can and have failed. They didn't fail during the 2008 crisis, but a senior financial regulator in office at the time tells us that one or more clearinghouses might have been in distress if the feds had not rescued the commercial paper market.

Clearinghouses had traditionally held the margin they collected in cash or Treasurys, but over time some of this money was invested in instruments with a higher yield and a triple-A rating from one of the government-selected credit-rating agencies. These assets became much more difficult to sell in the fall of 2008. Regulators thought about raising the issue at the time but didn't want to add to the panic. They have since pressed clearing organizations to keep only the most liquid financial instruments.

None other than current Fed Chairman Ben Bernanke has written as an academic about problems in Wall Street's clearing systems during the 1987 stock-market crash. Craig Pirrong, a University of Houston economist who has written for these pages, also believes clearinghouses might have failed in that crash if not for the Fed's aggressive provision of liquidity.

In markets where clearinghouses exist today, they constantly adjust margin requirements based on the market prices of the assets being traded. This works because they are liquid markets with timely price information. But many over-the-counter derivatives rarely trade and aren't easily analyzed. It will be a challenge for a clearinghouse to set appropriate margin levels if regulators mandate too many products for clearing.

Also, most clearinghouses that operate today set margins based on historic volatility. Everything works well as long as patterns continue as they have in the past, but as we have so painfully learned the worst crises involve assets long considered very safe that turn out to be risky. We now know that regulators at the Treasury's Office of Thrift Supervision signed off on AIG's credit-default swaps because they backed AAA-rated mortgage assets. And everyone *knew* housing had been rock-solid for decades.

Under its reform bills, Congress leaves most of the clearinghouse details to the Commodity Futures Trading Commission. Chairman Gary Gensler, a Goldman Sachs alum, will decide which swap transactions must be routed through a clearinghouse. An exception is the market for foreign-exchange swaps, a domain that will be ruled by Treasury Secretary Timothy Geithner.

If regulators make bad decisions (again) about credit risk in a world in which all deriveatives are in clearinghouses, they will confront the mothers of all too-big-to-fail institutions. Language in the derivatives portion of the bill written by Arkansas Senator Blanche Lincoln says that clearinghouses won't get bailouts. But regulators tell us they believe Mr. Dodd's more specific rescue authority would prevail in court.

To better protect taxpayers and force better clearinghouse discipline, Congress should strip out Mr. Dodd's discount window provision. As important, Americans should understand that Congress isn't ending financial risk in derivatives. It is merely redirecting that risk, while making taxpayers the ultimate backstop.